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GAO

Testimony

Before the Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance,
Committee on Banking, Finance and Urban Affairs
House of Representatives

For Release on Delivery
Expected at
9:30 a.m.
Thursday,
September 23, 1993

BANK AND THRIFT
REGULATION

FDICIA Safety and Soundness
Reforms Need to Be
Maintained

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Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to discuss H.R. 962, the Economic Growth and Financial Institutions Regulatory Paperwork Reduction Act of 1993. You asked for our comments on the effect this bill would have on credit availability and the safety and soundness of the industry. H.R. 962 contains many different provisions that are intended to reduce the burden of regulation on safe, sound, and properly managed financial institutions. While we are not in a position to comment on most of these provisions based on work we have performed, I want to emphasize GAO's support for efforts to reduce regulatory burden that does not compromise safety and soundness or other public interests. Earlier this month we issued a report that recommended ways to reduce the regulatory burden on small business lending,¹ and we have other work underway that I will discuss later.

We are concerned about several provisions of H.R. 962 that would weaken some of the safety and soundness reforms that were enacted by the Congress less than 2 years ago, many of which are still being implemented. These provisions run the risk of undoing much of the progress that has been made in reforming safety and soundness regulation without any assurance that they would spur much bank lending. Rolling back these reforms would place taxpayers needlessly at risk and could undermine other legislative efforts, such as interstate branching, to modernize the banking industry.

We believe that there are opportunities to reduce the regulatory burden that should be vigorously pursued by both the administration and the Congress. But in proceeding, it is important to consider all relevant benefits of regulation, as well as costs, together with longer term goals for the modernization of the banking industry.

My testimony is divided into two parts. First, based on work completed and in progress, I would like to provide some general comments on reducing regulatory burden, including a discussion of our small business lending report. Next, I will explain our concerns about the implications of the changes to safety and soundness provisions proposed by H.R. 962.

GAO WORK ON REDUCING REGULATORY BURDEN

The many provisions of H.R. 962 illustrate the wide range of topics that can be potentially addressed under regulatory burden. As the Subcommittee is aware, we have a study underway that is intended to develop greater understanding of burden issues. We are analyzing studies by industry groups and the banking agencies to understand

¹Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (GAO/GGD-93-121, September 7, 1993).

the methodology they have used in addressing burden and to see whether there are burden issues that can be clearly identified as high priorities. We anticipate that our report will be available by the end of the year. In another study, we are looking much more in depth at the Community Reinvestment Act. Through this study, we intend to review the industry's experience with the act and related fair lending laws from the perspective of bankers, regulators, and community groups. We anticipate that this study, which will focus on about 50 to 60 banks, will be finished in the spring.

Our work to date has given us an appreciation of the complexities of the regulatory burden issues. It is hard to find reliable data. Furthermore, while the cost of bank regulation is a vital issue for the industry and for the financial sector of the economy, it is also necessary to consider the benefits associated with regulation. Taken as a whole, the regulatory structure applicable to depository institutions is designed to benefit the public by providing industry stability, protection of depositor funds, and the availability of banking services. The system has also provided many benefits to the institutions themselves. These benefits include the right to accept insured deposits and access to the Federal Reserve's discount window. The markets have also allowed banks to operate with lower amounts of equity capital than markets may otherwise require without federal deposit insurance.

In view of this, the task of reducing the burden of regulation requires a careful assessment of the costs and benefits of proposed changes. In doing this, it is also important to distinguish between changes that may require legislation and those which can be dealt with by changes in agency regulations or supervision.

Small Business Lending

As I mentioned, earlier this month we issued a report on small business lending. We were asked to conduct this study to gain insights into ways safety and soundness regulation or supervision may be inhibiting the ability of sound banks to make traditional small business loans (loans to established businesses for such things as working capital and equipment) that would otherwise be justified by market conditions.

In part, this assignment involved unstructured interviews with officials in 38 banks of different sizes in 8 states as well as discussions with regulators. Our sample of banks was not intended to be a random sample and therefore the views expressed are not necessarily representative of the industry as a whole. We were, however, struck by the consistency with which bankers told us that compared to several years ago, they were seeking assurance that loans could be repaid from the businesses' cash flows. They attributed this shift toward tighter, more traditional credit standards, primarily to a response to the extraordinary loan losses incurred by the industry in the late 1980s and early 1990s, and

also to current uncertain economic conditions, particularly in some regions of the country.

However, there were two areas--real estate appraisals and bank examinations--where many felt that regulations were placing an excessive burden on the small business lending activities of sound banks. In looking more closely at these two areas, we found that there are actions that federal banking agencies can take to reduce regulatory impediments to small business lending without compromising essential safety and soundness standards. These actions do not require legislation and would make it clear that sound banks have flexibility in applying good business practices to their small business lending programs.

Turning first to appraisals--because inadequate or overstated appraisals contributed to costly thrift and bank failures during the 1980s--Congress directed the banking agencies in 1989 to strengthen the requirements for estimating the value of real estate that is to be pledged as collateral for a loan. While there is no question that action to correct abuses was needed, a problem for traditional small business lending was created by the broad scope of the implementing regulations and agency guidance. The agencies in essence required banks to obtain formal appraisals of real estate given as collateral for a traditional small business loan, even though banks expected the loan to be paid from the cash flow of the business. Bankers with whom we spoke told us that these appraisals would generally cost the borrower about \$3,000 or more and could delay processing a loan. The appraisal issue is important because in today's credit environment small companies are frequently required to provide collateral for loans. For example, one larger bank we contacted estimated that real estate is used to collateralize over 60 percent of its small business loans.

We concluded that real estate appraisal requirements can be safely modified when applied to collateral taken as supplementary support for traditional small business loans. Therefore, we agree with those aspects of the pending rule changes that have been recently proposed by the banking regulators to exempt such loans from a mandatory appraisal requirement.

We also concluded that the banking agencies needed to clarify the guidance given to banks about how to evaluate real estate collateral when an appraisal is not required. Currently, this guidance is not consistent and is subject to varying interpretation by banks. We recommend that the agencies make it clear that bankers in sound institutions can use their judgment in determining the most cost-effective way to evaluate the collateral for small business loans that are immaterial to the condition of a bank.

In the supervision area, in an effort to spur bank lending, the agencies have undertaken an interagency policy initiative to allow banks with adequate capital and satisfactory management to place

some loans in a "basket" with minimum documentation requirements and examiner attention. Many of the bankers with whom we spoke said this regulatory initiative will likely have a limited impact on small business lending because, as indicated earlier, banks have voluntarily increased their documentation and underwriting standards. Moreover, banks using the minimum documentation requirements will have to track those loans separately.

Allowing sound institutions greater flexibility in the administration of their small business loan program makes sense and is consistent with the approach to regulation contained in the FDIC Improvement Act of 1991 (FDICIA), which underscores the importance of capital and management and makes distinctions among institutions based on their soundness. We also believe that an effective way for the agencies to ensure that the examination process does not inhibit the small business lending activities of sound institutions is to focus their examinations on the institutions' systems of internal controls. If tests of controls show that a bank is adhering to good underwriting and credit administration policies, examiners would not have much reason to challenge management's judgments regarding individual small business loans.

In the near term, the changes we recommended with regard to appraisals and supervision are not likely to make a big difference in the volume of lending because of the importance of other factors, such as demand for loans. However, these changes are nonetheless important because they would help soundly managed institutions to respond more confidently to an increase in loan demand. Building up a greater degree of trust between the industry and the regulators, based on a common understanding of good business practices, can only be beneficial to the economy.

Simplifying the Supervisory Process

In February 1993, we testified on the results of our review of the bank and thrift regulators' safety and soundness examinations.² We identified inconsistencies and overlap in the four regulators' examination policies and practices. These inconsistencies included differences in examination scope, frequency, documentation, and assessment of critical areas, such as loan loss reserves. Such differences could result in disparate conclusions regarding the safety and soundness of an institution, depending on which regulator does the assessment.

Although we did not study the efficiency and effectiveness of the regulatory structure as a whole, we believe the examination overlap

²Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/T-AFMD-93-2, February 16, 1993).

and inconsistencies we found are symptomatic of the difficulty of efficiently and effectively regulating the banking and thrift industries with four separate federal regulators. The current regulatory structure has evolved over decades of legislative efforts to address specific problems, resulting in a fragmented system that may no longer be capable of handling the complexities of today's banking and thrift industries. We believe that the system's weaknesses result in the potential for inequitable regulation of banks and thrifts and may place an unnecessary burden on the industry. We believe the inefficiencies in the regulatory examination process also extend to the overlap between the work conducted by the examiners in reviewing loans and related internal controls and the work of the banks' external auditors. Although legislation is needed to restructure the regulatory agencies, FDICIA already provides the basis for the regulators and auditors to better coordinate their work.

SAFEGUARDS TO PROTECT THE
BANK AND THRIFT INSURANCE FUNDS
SHOULD NOT BE WEAKENED

While we support efforts to reduce regulatory burden, we are concerned about proposals that would eliminate or reduce the effectiveness of some of FDICIA's safety and soundness reforms. From 1980 through 1992, approximately 2,700 banks and thrifts failed, costing the insurance funds and taxpayers roughly \$200 billion. FDICIA's reforms are essential for protecting healthy banks and the taxpayers from excessive deposit insurance costs.

The key FDICIA safety and soundness provisions are (1) requirements for prompt corrective action for institutions failing to meet specified capital and safety and soundness standards, (2) management and auditing reforms for institutions with assets of \$150 million or more (raised to \$500 million by FDIC regulations) that highlight private sector responsibility for protecting taxpayers from losses, (3) accounting reforms to provide accurate information to management, regulators, and the public, (4) annual, on-site examinations for most institutions to detect problems on a more timely basis, and (5) changes in the way institutions are closed so that uninsured depositors and general creditors will be more likely to share in the losses if an institution fails.

H.R. 962 proposes eliminating or altering several of FDICIA's safety and soundness reforms concerning prompt regulatory action supervisory and accounting requirements. The stated purpose of H.R. 962 is "to increase the amount of credit available to fuel local, regional, and national economic growth by reducing the regulatory burden imposed upon safe, sound, and properly managed financial institutions." We believe the proposals to change the safety and soundness requirements, although well intended, are misguided and may very well have the effect of removing early

warning signals of safety and soundness problems and therefore eliminating the opportunity for both bank management and regulators to correct problems before they overwhelm the institution and result in losses to the deposit insurance funds.

The prompt corrective action, supervisory, and accounting and auditing provisions of FDICIA are critically linked to protect the insurance funds. In other words, the examiner visits the institution once a year to observe its functioning first-hand, management is required to protect the insurance funds through effective corporate governance, and guidance is provided to the regulators to ensure that banks and thrifts maintain the minimum capital levels and safety and soundness standards to guard against losses to the insurance funds. In addition, the accounting provisions are fundamental to ensure financial reports that accurately reflect the financial condition of the institution and to facilitate effective supervision and, if necessary, action to resolve troubled institutions at the least cost to the insurance funds.

We have issued reports and testified a number of times concerning why the reforms I just discussed are so important.³ We have

³Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

Thrift Failures: Costly Failures Resulted from Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Financial Condition of the Federal Deposit Insurance Corporation's Bank Insurance Fund (GAO/T-AFMD-89-15, September 19, 1989).

Prevention, Detection, and Reporting of Financial Irregularities (GAO/T-AFMD-90-27, August 2, 1990).

Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

Additional Reserves and Reforms Are Needed to Strengthen the Bank Insurance Fund (GAO/T-AFMD-90-28, September 11, 1990), letter to the Chairman, Senate Committee on Banking, Housing and Urban Affairs (B-114831, September 13, 1990), and letter to the Chairman and Ranking Minority Member, House Committee on Banking, Finance and Urban Affairs (B-114831, September 21, 1990).

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991).

Deposit Insurance: A Strategy for Reform (GAO/T-GGD-91-12, March 7, 1991).

analyzed the bank and thrift failures and the effectiveness of enforcement actions taken by the regulators. The consistent finding was that serious managerial and internal control weaknesses contributed significantly to the failures and that enforcement actions were not forceful or timely enough to correct the problems identified by the examiners. Also, flexible accounting rules allowed institutions to hide their losses.

In our review of audit committees⁴ of banks with \$10 billion or more in assets, many audit committee chairmen told us their members lacked independence, the expertise related to their responsibilities as audit committee members, and adequate information on internal controls and compliance with laws and regulations in key areas of bank operations. Clearly this is an unacceptable situation.

Audit committees are intended to play a very important role in the corporate governance of banks. Their responsibilities should include monitoring banks' internal controls and ensuring that management is not overriding internal controls, supervising the activities of internal and external auditors, and reviewing financial statements and important accounting policies. Audit committees need to be made up of independent outside directors to enable an impartial review of management's conduct of bank business.

FDIC Issued Limited Regulations
to Implement Section 112 of FDICIA

Section 112 of the act pertains to management and auditor reporting on internal controls and compliance with safety and soundness laws and regulations designated by FDIC, and to independent audit committee requirements. FDIC elected to issue limited regulations

Bank Supervision: Prompt and Forceful Regulatory Actions Needed
(GAO/T-GGD-91-15, March 14, 1991).

Bank Supervision: Prompt and Forceful Regulatory Actions Needed
(GAO/GGD-91-69, April 15, 1991).

Failed Banks: Accounting and Auditing Reforms Urgently Needed
(GAO/AFMD-91-43, April 15, 1991).

Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, September 16, 1991).

OCC Supervision of the Bank of New England (GAO/T-GGD-91-66, September 19, 1991).

⁴Audit Committees: Legislation Needed to Strengthen Bank Oversight
(GAO/AFMD-92-19, October 21, 1991).

to implement section 112 and also to provide minimal guidelines. In FDIC's discussion of the final rule issued June 2, 1993, FDIC stated that its approach was consistent with the letter and spirit of the law and with comments received that the final rule "not impose unnecessary regulatory burdens, provide appropriate flexibility, and be reasonably cost-effective."

In this case, we believe that FDIC has allowed institutions too much flexibility with respect to the section 112 requirements. We advised the FDIC Board of Directors on May 10, 1993, that such limited regulations and guidance would result in a serious weakening of the act's reforms, which were intended to prevent a recurrence of the breakdowns in internal controls and flawed systems of corporate governance that contributed to the savings and loan crisis and bank failures. H.R. 962 was introduced on February 18, 1993, before the final FDIC regulations were issued in May 1993. Given FDIC's actions, we believe it would be a serious mistake to further weaken the corporate governance reforms as proposed by H.R. 962.

Regulators Have Written Proposed
General Standards to Implement
Section 132 of FDICIA

Section 132 of FDICIA adds a noncapital component to the prompt corrective action provisions. Among other things, it requires regulators to establish various operational and managerial standards in the areas of internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, and asset growth. These provisions are to become effective no later than December 1, 1993.

We believe Section 132 is a crucial component of prompt corrective action. Because falling capital levels are a lagging indicator of problems in a bank or thrift, this section provides regulators a basis for acting earlier to correct unsafe and unsound practices. These provisions, therefore, need to be enforced at all institutions and we oppose H.R. 962's proposals to selectively implement these requirements.

Section 132 has been widely misunderstood to call for highly detailed and restrictive rules for bank behavior. I see no reason why regulations have to lead to such a result, nor does FDICIA require it. On the contrary, actions by the regulators to establish the standards are in the opposite direction. In July 1992, the regulators issued an advance notice of proposed rulemaking to obtain public comments on all aspects of the safety and soundness standards. The majority of comments received were from insured depository institutions and holding companies. Those who commented recommended that the regulators adopt general rather than specific standards in order to avoid regulatory micromanagement of the banking and thrift industries.

Based on these comments, the regulators are now preparing proposed regulations for public comment. A draft of the proposed rulemaking has been approved by FDIC and the Federal Reserve Board and is currently being reviewed by Treasury. The draft proposed regulations state that the "proposed standards are specific enough to identify emerging safety and soundness problems and require submission of a compliance plan before those problems become serious; however, the standards do not specify each operational and managerial procedure an institution must have in place." For example, the

"proposed regulations do not specify in detail what loan documentation must contain. Instead, they specify what loan documentation must enable an institution to do. Thus, documentation practices at an institution will not be evaluated against a checklist of requirements but instead will be evaluated based on whether they: (1) enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis; (2) identify the purpose of the loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; (3) ensure that any claim against a borrower is legally enforceable; (4) demonstrate appropriate administration and monitoring of a loan; and (5) take account of the size and complexity of a loan. The agencies believe that the proposed regulation provides a standard against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation."

We agree with the regulators that "under the proposed regulations, well-managed institutions generally should not find it necessary to amend their operations in order to comply with the operational and managerial standards."

Rules for Fair Market Value Disclosures
Required by Section 121 of FDICIA
Not Yet Completed

The accounting reforms required by Section 121 of FDICIA include reporting by banks and thrifts of the estimated fair market value of their assets and liabilities to the extent feasible and practicable. The regulators are currently evaluating comments they received on the feasibility of such reporting. H.R. 962 would repeal the FDICIA market value disclosure requirements.

We believe disclosure of the fair value of assets and liabilities is information that regulators need to fully understand the financial condition and activities of banks and thrifts. Generally accepted accounting principles are largely based on reporting that uses historical costs, which may differ significantly from fair values. Also, institutions may have activities off the balance sheet that equal or exceed their assets and liabilities reported on

the balance sheet. The failed Bank of New England is an example of an institution that reported about \$30 billion in assets on its balance sheet and had about an equal amount of off-balance activities that exposed the bank to potential losses. In that respect, the widespread use of derivative products, both by large banks, who are dealers and end users of products, and smaller institutions, who are generally end users, is another important reason for disclosure of fair market values. While derivative products, properly used, are valuable tools for hedging interest rate risks, they can be extremely complex and can involve substantial risk of loss.

Currently, accounting rules require disclosure of information about financial instruments with off-balance sheet risk of loss. Also, entities are required to disclose the fair value of financial instruments, both assets and liabilities recognized on the balance sheet and those not recognized, for which it is practicable to estimate fair value.⁵ If estimating fair value is not practicable, entities are required to disclose information pertinent to estimating fair values of financial instruments and why it is not practicable to estimate fair value. The FDICIA requirement parallels current accounting rules, although it extends fair value disclosures to nonfinancial assets and liabilities. Although the regulators are correct in obtaining public comments regarding the feasibility of enhanced disclosure requirements, we believe that any exceptions allowed by the regulators in the final regulations should be clearly justified. In addition, we believe that consistent with current accounting rules, the final regulations should require that reports submitted by institutions to the regulators that do not disclose fair market values for reasons of practicality should explain why it is not feasible to do so.

Improved Industry Performance
Does Not Mean Essential Safeguards
Should Be Removed

The performance of the banking and thrift industries has rapidly improved by any number of indicators--be it net income, return on assets, or capital levels. The rapid turnaround of the banking industry in particular demonstrates the volatility of the business of banking and its effect on the Bank Insurance Fund. It took just 4 years to deplete the Fund's 1987 net worth of \$18.3 billion. In about 18 months, the Fund's balance has improved from a \$7 billion deficit at December 31, 1991, to an unaudited balance of about \$6 billion at June 30, 1993. We agree with the statement made by the Acting FDIC Chairman when releasing the June 30 numbers that

⁵For entities with less than \$150 million in total assets, these asset/liability disclosure requirements are effective for fiscal years ending after December 15, 1995.

caution is needed. The Fund's reserve levels are 35 cents for every \$100 of insured deposits, well below the reserve of \$1.25 designated by the Federal Deposit Insurance Act. The number of problem banks, although decreasing, stands at 640 with assets of \$363 billion.

The improved condition of the Fund is attributable to increased insurance assessment income as well as substantial declines in actual and estimated losses from bank failures. Extraordinary interest rate spreads in 1992, continuing into 1993, rescued a number of failing banks and are largely responsible for the turnaround in the condition of the industry. The safety and soundness reforms of FDICIA, particularly the prompt corrective action requirements, have provided incentives to build capital and maintain financial stability as industry conditions improved.

It is important to understand that the prompt corrective action, supervisory, and accounting and auditing requirements collectively serve to provide an early warning of conditions that may need both bank management and regulator attention before they turn into serious problems. Accepting deposits and investing them in loans makes banking an inherently risky business, as demonstrated by the banks' experience with transactions involving lesser developed countries, leveraged buyouts, and commercial real estate. Large banks are now using highly complex financial derivatives that can expose them to credit and market risks. Breakdowns in internal controls need to be identified before deterioration of asset values and losses occur and capital levels are eroded. FDICIA's intent should be viewed as providing all banks and thrifts with incentives to operate with sound controls, and well managed banks should have no trouble meeting such standards.

In summing up the importance of the safeguards provided by FDICIA, it is essential that we not lose sight of the market environment that makes the new reforms so essential. In today's competitive markets, banks and thrifts must be well capitalized and have good management controls to operate safely and to protect the insurance funds. The safety and soundness reforms proposed to be eliminated or altered by H.R. 962 may inadvertently cause banks and thrifts and their regulators to pay insufficient attention to the realities of sound banking in the current environment.

CONCLUSIONS

In conclusion, we want to encourage efforts to identify and reduce burden when there is a clear benefit to do so. At the same time, we believe the Congress, the administration, and the regulators should exercise great caution in considering short-term measures to encourage more liberal lending practices by insured institutions. Over time, a healthy banking industry is the best support for the economy, and it would not be prudent, in my opinion, to attempt to periodically weaken and tighten bank regulation in response to

recession and inflation. Had the banking system not dissipated its capital in the 1980s by making so many bad loans, it would have been better able to handle some of the problems encountered as the economy slowed. As the FDICIA reforms take hold, we can be more confident of the regulators' ability to successfully supervise banks in today's competitive market place and during times of future economic distress. It also becomes more feasible for the Congress to consider ways of expanding the business opportunities for the industry without placing the deposit insurance system and the taxpayers at risk.

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